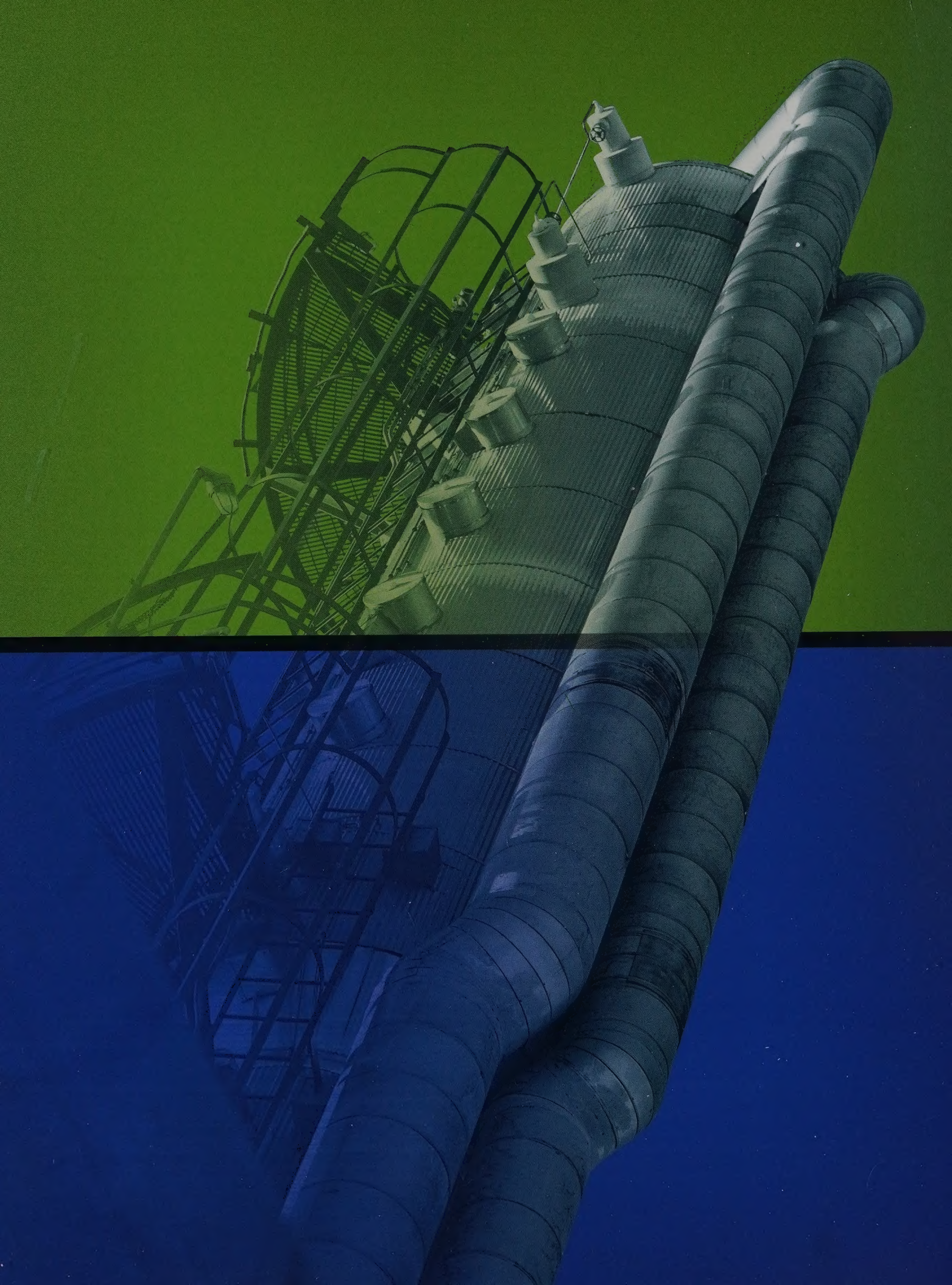
Rio Alto Exploration Ltd.

1998 Annual Report



Corporate Profile - Rio Alto Exploration Ltd.

Rio Alto's unwavering commitment to efficient operations has proven successful for the Company for more than a decade. This strategy will not change.

Rio Alto Exploration Ltd. is a highly focused exploration and production company, operating in the Western Canadian Sedimentary Basin and based in Calgary, Alberta. The Company's two core areas provide all of Rio Alto's production, 83 percent of which is natural gas. Rio Alto's operations are underpinned by its key growth strategies: strict cost control; geological and geographic focus; high working interests and operatorship; and solid debt management. Over the past 11 years, Rio Alto has consistently been named one of the lowest cost operators in the Canadian energy industry. Rio Alto is listed on the Toronto Stock Exchange, trading under the symbol "RAX".

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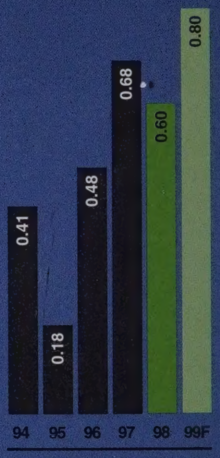
THE ANNUAL MEETING OF SHAREHOLDERS WILL BE HELD AT 3:00 P.M. ON WEDNESDAY, MAY 26, 1999 IN THE MCMURRAY ROOM OF THE CALGARY PETROLEUM CLUB, 319 - 5TH AVENUE S.W., CALGARY, ALBERTA.

Financial and Operating Highlights

Rio Alto shareholders invest in a company that ensures their money is well spent. Over the past 11 years, we have honed our ability to generate growth and build shareholder value in the most cost effective ways possible. Shareholders benefit from our steady growth in production achieved with a strong emphasis on cost control.

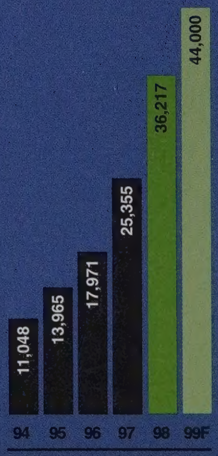
Cash Flow Per Share ($)

Higher production levels and the Company's tight cost controls grew cash flow 25 percent and cash flow per share six percent in 1998.



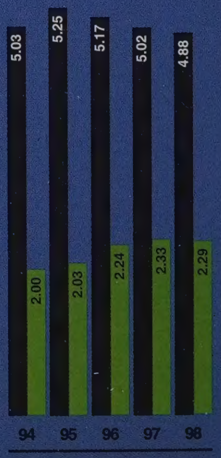
Net Income Per Share ($)

Rio Alto's net earnings remained strong due to the Company's low cost structure, despite lower product prices.



Net Production (boe/d)

Production growth of 43 percent met the Company's target set for the year.



Unit Operating Costs ($/boe)

Liquids

Natural Gas

The Company remains the industry's low-cost leader, with reduced operating costs for all products.

Financial Highlights

($THOUSANDS, EXCEPT PER SHARE AMOUNTS)	1998	1997	% CHANGE
Revenue	247,507	186,812	32
Cash flow	135,624	108,831	25
Per share	2.18	2.05	6
Net earnings	37,208	36,139	3
Per share	0.60	0.68	(12)
Capital expenditures			
Land acquisition and retention	24,644	27,681	(11)
Exploratory seismic	14,993	17,695	(15)
Acquisitions	206,795	329,888	(37)
Proceeds on disposition	(1,035)	(111,863)	(99)
Exploration and development	142,195	140,596	1
Total	387,592	403,997	(4)
Long-term debt, net of working capital	470,117	336,090	40
Shareholders' equity	421,676	278,437	51
Weighted average number of common shares outstanding (000s)	62,118	53,075	17

Operating Highlights

	1998	1997	% CHANGE
Production			
Natural gas (mcf/d)	299,600	225,300	33
Oil and NGLs (bbls/d)	6,257	2,825	121
Average sales price			
Natural gas ($/mcf)	1.98	2.01	(1)
Oil and NGLs ($/bbl)	14.29	22.02	(35)
Operating costs			
Natural gas ($/mcf)	0.23	0.23	–
Oil and NGLs ($/bbl)	4.88	5.02	(3)
Combined basis ($/boe)	2.74	2.62	5
Reserves - proven plus probable			
Natural gas (bcf)	1,263	950	33
Oil and NGLs (mbbls)	40,942	27,949	46
Wells drilled			
Gross	148	189	(22)
Net	131.3	169.1	(22)
Land holdings			
Gross (000s acres)	3,009	2,584	16
Net (000s acres)	2,523	2,064	22

Report to Shareholders

THE INDUSTRY'S ATTENTION HAS BEEN DRAWN TO NATURAL GAS OVER THE PAST YEAR AS MAJOR EXPORT PIPELINE PROJECTS GOT UNDERWAY AND OIL PRICES DROPPED SIGNIFICANTLY.

RIO ALTO'S CONSISTENT FOCUS ON NATURAL GAS HAS AFFORDED THE COMPANY ANOTHER YEAR OF SOLID FINANCIAL RESULTS AND SIGNIFICANT PRODUCTION GROWTH.

Rio Alto maintained its strong growth profile in 1998, achieving significant improvements in both financial and operational results. The Company's 11-year strategic focus on natural gas-prone core areas and equally long track record of low-cost operations continues to set the Company apart from its peers. Total average production for 1998 rose more than 40 percent to 362 million cubic feet equivalent per day. Currently, natural gas volumes account for 83 percent of production, rising to 93 percent when natural gas liquids are included. Natural gas prices in 1998 remained relatively strong. As a result, Rio Alto's cash flow increased 25 percent over 1997 to $135.6 million, or on a per share basis by six percent to $2.18 per share. Further, Rio Alto was once again named the lowest-cost operator last year in the Western Canadian Sedimentary Basin, based on an independent survey of the top 100 public oil and gas companies.

Downward pressure on crude oil pricing dramatically reduced energy industry activity towards the end of 1998 and affected netbacks for many companies. Rio Alto, however, continued generating strong netbacks due to relatively high gas prices and consistently low operating costs.

Although 1998 was a volatile year in the stock market, Rio Alto retained investor confidence, outperforming most of its peers. In the spring of 1998, the Company completed an equity issue, selling six million shares at $16.90 per share for net proceeds of $97 million. As a result of Rio Alto's market capitalization exceeding $1 billion during 1998, and its production growing to over 300 million cubic feet of natural gas equivalent per day, Rio Alto was elevated into the senior producer ranks by most oil and gas analysts. The Company was also added to the Toronto Stock Exchange's TSE 300 Index list during 1998.

These accomplishments are directly related to the Company's strategic focus on specific geological targets within two geographic regions of Northwest and Northeast Alberta. The Company maintains high working interests, averaging over 74 percent in 1998, and operates over 98 percent of its production. To maximize the value of these assets, the Company retains highly talented professional staff at its head office and in the field. The success of these strategies has led to clear competitive advantages and consistent growth for the past 11 years in both high and low industry cycles.

In 1998, Rio Alto capitalized on the weakening industry environment to acquire significant undeveloped land and underutilized production and facilities. The Company invested $206 million to strengthen its position in existing assets through five major acquisitions and a series of small- to medium-sized transactions. Undeveloped acreage was also expanded through purchases at Crown land sales. As a result, Rio Alto's net undeveloped land base grew by 23 percent to 1.84 million acres.

WITH MARKET CAPITALIZATION OVER $1 BILLION AND PRODUCTION EXCEEDING 400 MILLION CUBIC FEET OF NATURAL GAS EQUIVALENT PER DAY, RIO ALTO HAS REACHED THE RANKS OF SENIOR PRODUCER.

Four major acquisitions were completed in the Northwest Alberta core area where Rio Alto consolidated its position at Minehead and established a strong stake at Gold Creek. Three Gold Creek area acquisitions gave the Company operatorship and a significant interest in a major gas plant with net processing capacity of 100 million cubic feet per day with associated sulphur recovery capability.

A fifth major acquisition during the year was at Liege in Northeast Alberta, where the Company purchased a significant share of the current operation and now controls three-quarters of the field. When combined with a number of minor transactions completed during the year, Rio Alto increased production by 55 million cubic feet equivalent per day through strategic acquisitions. Subsequent to year end, the Company acquired 100 percent ownership positions in four major contiguous producing properties in Northeast Alberta.

By dedicating approximately 60 percent of the 1998 capital budget to property acquisitions, Rio Alto continued an aggressive forward-looking program which has been in place for the past 18 months. With this strategy, Rio Alto is building a strong inventory of development opportunities to ensure a competitive advantage through all the cycles of the natural gas industry. With natural gas export pipeline expansions onstream and current supply shortages from western Canada, Rio Alto's position as a major gas producer will continue to strengthen.

In addition to growth through acquisitions, Rio Alto added significant volumes through an active drilling program. Despite a warm winter at the beginning of the year which shortened the drilling season, Rio Alto drilled 148 wells (131.3 net) in 1998. The program achieved a 77 percent success rate and added 80 million cubic feet equivalent per day in natural gas production and 266 billion cubic feet natural gas equivalent in proven reserves.

Due to the aggressive acquisition program, 1998 finding and development costs increased to $7.55 per barrel of proven plus half probable oil equivalent reserves. Although this represents an increase over last year, Rio Alto's finding and development costs remained below the industry average and were in line with the overall industry increases in 1998.

While natural gas prices were somewhat lower than expected in 1998, prices strengthened later in the year due to increased demand. In mid-December, further price strength was seen as incremental take-away capacity from Alberta came onstream via the expansion of the Northern Border Pipeline to the U.S. Midwest. This addition of 700 million cubic feet per day of export capacity caused the price gap between U.S. and Alberta gas prices to narrow, benefitting Canadian producers. Further price support is expected in 1999 as Canadian producers profit from improved access to higher-priced markets.

The Company's strategy for 1999 remains consistent with the proven principles of past years. Growth plans for 1999 will emphasize drilling activity on lands acquired in 1998 and earlier. The Company's first priority will be to drill new prospects with an emphasis on the Northwest where larger reserve targets provide a longer reserve life. Prior to the acquisitions closing earlier this winter, Rio Alto had already completed most of its property evaluations and prioritized much of the development activity for 1999. Once again the Company anticipates a further year of solid growth.

Rio Alto's 1999 capital expenditures are budgeted at $220 million, which includes a significant acquisition program. In the first quarter, Rio Alto spent over $90 million acquiring reserves and production in existing operations in the Newby, Chard and Tweedie areas of Northeast Alberta. In addition, high-potential winter drilling was completed in many of the Company's core areas, where a program of 90 (83 net) wells has been completed, which is consistent with the level of drilling last year.

The 1999 target is to increase overall production by greater than 20 percent over 1998, with daily natural gas production expected to grow to approximately 367 million cubic feet and total liquids to average around 7,300 barrels per day. With that level of production, cash flow for 1999 is forecast to reach $185 million or $2.85 per share, based on an average natural gas price of $2.25 per thousand cubic feet and a crude oil and liquids price of $15.00 per barrel.

Looking to 1999, Rio Alto is a senior Canadian natural gas company with substantial growth potential. Management will continue to apply its strategies which have provided consistent growth for the Company and capital appreciation for shareholders. As owners of an aggressive natural gas-leveraged company, Rio Alto's shareholders stand to benefit from the Company's disciplined cost control, the strong inventory of drilling prospects and the financial and technical strength to continue to grow through acquisition, exploration and development.

The management of Rio Alto would like to thank its employees for their dedication and hard work, the Board of Directors for their guidance and shareholders for their valued and continuing support.

On behalf of the management team and Board of Directors,

Richard T. Cones
President and Chief Financial Officer

Robert M. Shaunessy
Executive Vice President, Operations and Chief Operating Officer

February 22, 1999

GROWTH PLANS FOR 1999 WILL FOCUS ON DRILLING ACTIVITY ON LANDS ACQUIRED IN THE LAST FEW YEARS, WITH PARTICULAR EMPHASIS ON NEW PROSPECTS IN THE NORTHWEST CORE AREA.

Review of Operations

Rio Alto's operations are focused in two gas-prone core areas: Northwest and Northeast Alberta. In both of these areas, the Company's key strengths are high working interests, low-cost operations, a high level of operatorship and expansive undeveloped lands.

Northwest Alberta

The core Northwest Alberta area has become Rio Alto's highest region of growth. The Company has combined its proven exploration expertise with acquisitions to generate significant production and reserve growth in this area over the past few years. In 1998, gas production from the area grew significantly to 44 percent of the corporate total, up from 35 percent in 1997. This was achieved through an active and successful drilling program and a series of acquisitions which added extensive undeveloped lands and a large inventory of high-potential drilling prospects.

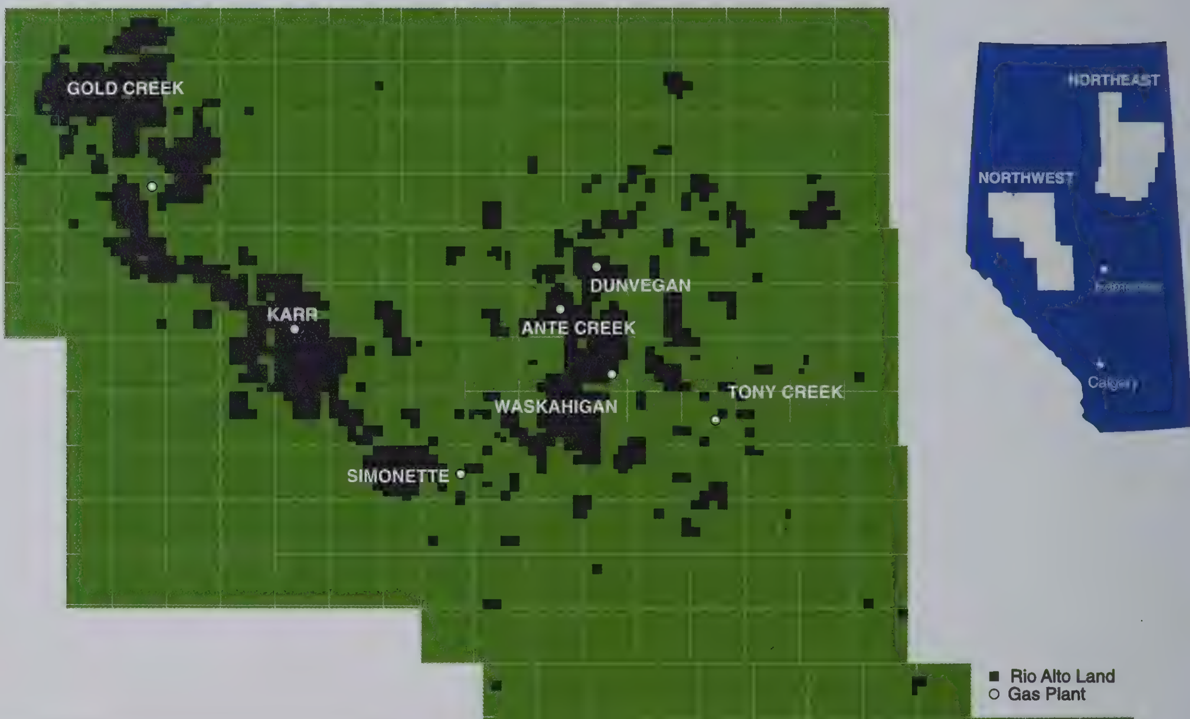
Northwest Alberta is characterized by liquids-rich natural gas at greater depths than Rio Alto's original Northeast core region. The targets tend to be more geologically complex and the wells more expensive to drill than those of the Northeast. However, these deeper horizons yield large reserve accumulations with long reserve lives. The risk profile is mitigated by the multi-zone potential of the wells, with some targeting up to three potential producing zones. The area's production profile is currently 70 percent natural gas, 20 percent natural gas liquids and 10 percent crude oil and condensates. Over the past year, natural gas production in the region has increased 67 percent while liquids production has grown 121 percent.

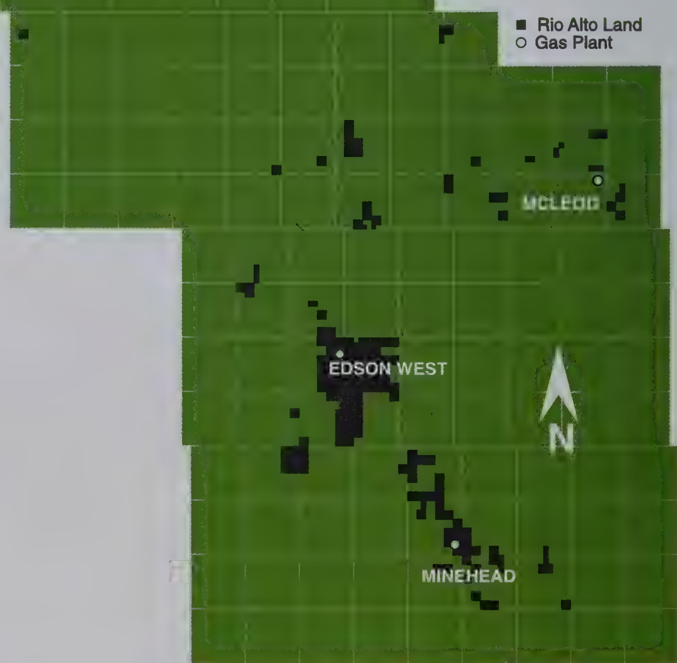
Northeast Alberta

Northeast Alberta remains a solid production area for Rio Alto. This core area provides a steady base of low-cost operations with production being exclusively natural gas. The area is characterized by shallow producing horizons which can be drilled quickly at a relatively low cost. Drilling success rates are high and wells typically target one or two potential producing zones.

Activities in 1998 focused on strengthening the Company's presence in the area through both drilling and a major acquisition at Liege. This acquisition strategy was further expanded with a large acquisition in the first quarter of 1999 which added daily production of 35 million cubic feet and significantly expanded Rio Alto's land holdings, reserves and prospect inventory.

Northwest Alberta





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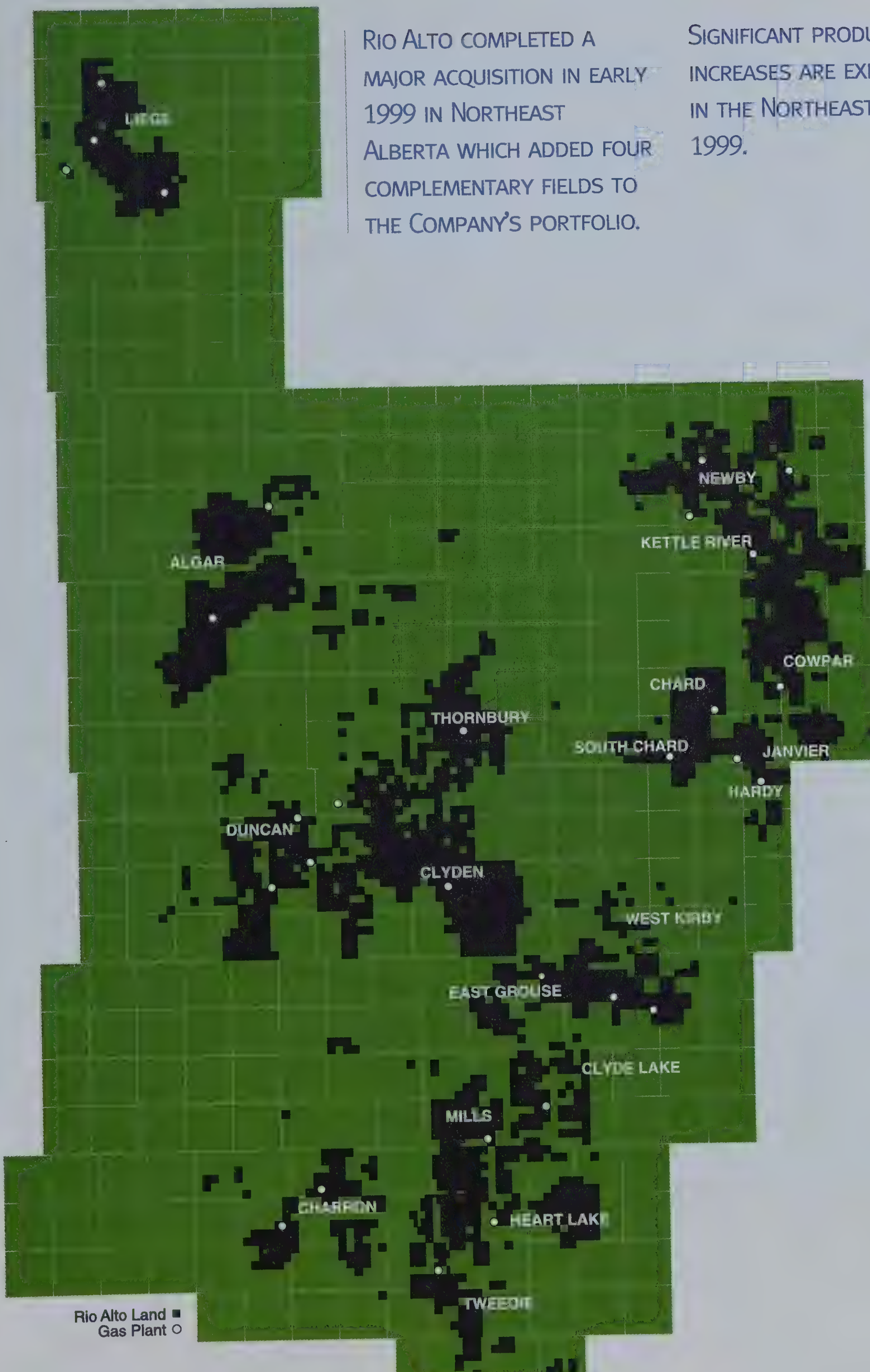
Four major acquisitions at Gold Creek and Minehead, completed in 1998, consolidated Rio Alto's holdings in the Northwest core area. In 1999, the Company will continue to pursue opportunities to increase production through drilling and acquisitions.

1998 Land Summary

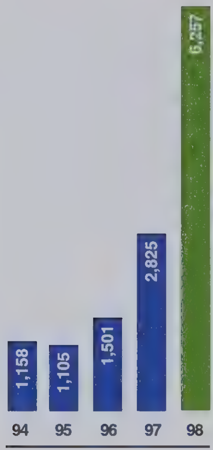
(Thousands of acres)	Northwest		Northeast		Total	
	Gross	Net	Gross	Net	Gross	Net
Developed	287	205	618	475	905	680
Undeveloped	1,116	985	988	858	2,104	1,843
Total	1,403	1,190	1,606	1,333	3,009	2,523

Northeast Alberta



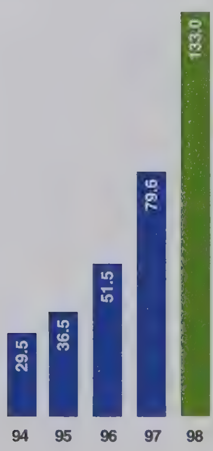
Rio Alto completed a major acquisition in early 1999 in Northeast Alberta which added four complementary fields to the Company's portfolio.

Significant production increases are expected in the Northeast in 1999.



NORTHWEST NET OIL AND NGL PRODUCTION
(BBLS/D)

Oil and NGL production more than doubled as Rio Alto completed strategic acquisitions and a strong development drilling program in 1998.



NORTHWEST NET NATURAL GAS PRODUCTION
(MMCF/D)

The Northwest core area contributed 44 percent of Rio Alto's natural gas production in 1998, compared to 35 percent in 1997.

NORTHWEST ALBERTA

Northwest Alberta remains a primary focus area for the Company due to the competitive nature of the region. The Company actively pursues opportunities to increase production through drilling and acquisitions, and to expand its land position to enhance an already extensive prospect portfolio. In 1998, the Company completed four major acquisitions to consolidate its holdings in this multi-horizon, liquids-rich region. In addition, a program of minor acquisitions in existing properties was completed, along with a significant expansion of the land base through Crown land purchases. This focused acquisition strategy enables Rio Alto to apply its proven exploration and exploitation expertise to an expanding opportunity base through facilities that are controlled and operated by the Company.

A new area in the Northwest has been Gold Creek, located immediately north of the Company's operations at Karr. In 1998, Rio Alto moved to strengthen its position in the area through $130 million in acquisitions for the majority of the Gold Creek property, gas plant and gathering systems. These transactions added over 40 million cubic feet per day of natural gas equivalent production. Rio Alto also gained a significant additional interest in and operatorship of the large area plant and gathering system. This is the Company's first major sour gas processing facility. Further growth opportunities at Gold Creek were enhanced by the addition of 91,300 net acres of undeveloped land included in the acquisitions.

Another major acquisition was completed at Rio Alto's Minehead property. The deal added six million cubic feet equivalent per day of natural gas and liquids production and approximately 1,400 net undeveloped acres. A further acquisition was completed at the existing Tony Creek property on the eastern flank of the Company's operating region, adding two million cubic feet per day of natural gas production and additional infrastructure. Other small to medium-sized transactions further strengthened the Company's position, notably in the Karr area. This aggressive acquisition strategy has built a strong portfolio of exploration and development opportunities that will carry Rio Alto well beyond its 1999 drilling and completion plans.

These acquisitions have strategically strengthened the Company's operational base in the Northwest and allowed Rio Alto to secure control of the key infrastructure elements in its operating region.

The 1998 Northwest drilling program included 77 wells (65.1 net) of the Company's total 148 well program. The drilling success rate in the Northwest was 78 percent.

Development activities focused on new compression facilities installed at Karr, Edson and Tony Creek to accommodate the flow rates from new wells. In addition, 48 new wells were tied into new and existing Northwest facilities. Production gains in 1998 were very strong. Natural gas average production increased 67 percent to 133 million cubic feet per day, and crude oil and natural gas liquids were up 121 percent to 6,257 barrels per day. The majority of this strong liquids gain was attributable to the Karr, Gold Creek and Edson areas.

Area capital spending in 1998 totalled $317 million, of which $190 million was dedicated to acquisitions and the remainder to exploration and development activities, drilling and Crown land sales.

In 1999, Rio Alto has budgeted $105 million for activity in the Northwest. Drilling will account for $82 million, with particular emphasis on the newly acquired lands. Rio Alto's high level of operating success, along with acquisitions and consolidations, will ensure the Northwest remains a key growth area for the company.

Northwest Natural Gas Production

ANNUAL AVERAGE (MMCF/D)	1998	% OF COMPANY TOTAL	1997	% OF COMPANY TOTAL
Waskahigan/Ante Creek	36.6	12.2	40.3	17.9
Karr/Simonette	36.5	12.2	20.2	9.0
Edson West	20.9	7.0	7.1	3.1
Tony Creek	13.8	4.6	6.6	2.9
Gold Creek	11.8	3.9	–	–
Minehead/Peco	5.7	1.9	4.2	1.9
Mcleod	4.2	1.4	1.2	0.5
Dunvegan	3.5	1.2	–	–
Total	133.0	44.4	79.6	35.3

Northwest Oil and NGL Production

ANNUAL AVERAGE (BBLS/D)	1998	% OF COMPANY TOTAL	1997	% OF COMPANY TOTAL
Karr/Simonette				
Oil	83	1.3	79	2.8
NGLs	2,006	32.1	998	35.3
Gold Creek				
Oil	125	2.0	–	–
NGLs	972	15.5	–	–
Edson West				
Oil	74	1.2	59	2.1
NGLs	1,022	16.3	334	11.8
Waskahigan/Ante Creek				
Oil	504	8.1	544	19.3
NGLs	720	11.5	567	20.1
Minehead/Peco				
Oil	–	–	–	–
NGLs	271	4.3	89	3.1
Mcleod				
Oil	35	0.6	12	0.4
NGLs	226	3.6	56	2.0
Tony Creek				
Oil	33	0.5	23	0.8
NGLs	186	3.0	64	2.3
Total	6,257	100.0	2,825	100.0

Rio Alto's aggressive acquisition program, combined with our proven exploration and development ability, has generated solid growth for the Company.

Our large inventory of undeveloped land ensures we will continue to grow our production and our company well into the future.

Northeast Alberta

Rio Alto's success in Northeast Alberta has been accomplished through low-cost operations and a successful exploration and development program. Production is solely natural gas and multi-zone horizons are found at depths of less than 500 metres. To improve the Company's overall drilling success and maintain cost efficiencies, the Company utilizes extensive seismic and technologies such as horizontal drilling. Success has also hinged on the Company's experience in the region through a knowledgeble, multi-functional team dedicated to the Northeast.

Production increased 14.5 percent in the Northeast in 1998 to 166.6 million cubic feet per day. This gain resulted from a combination of drilling, acquisitions and facility optimization. Rio Alto drilled 71 (66.2 net) natural gas wells with a 75 percent success ratio, while retaining an average working interest of 78 percent. By the end of last winter's drilling program, an incremental 25 million cubic feet per day of new gas production had been added through the drill bit.

Capital expenditures in this area in 1998 totalled $71 million, including $11.4 million for the acquisition of a consolidating interest in the Liege area. Rio Alto now holds a 75 percent interest at this large producing field. This transaction added net daily gas production of five million cubic feet, more than 12,000 net undeveloped acres and net developed acreage exceeding 7,000 acres. Further production gains were recorded through the addition of compression facilities at Liege and Newby. Overall, 62 new wells were tied in to Company-operated facilities.

Significant production increases are expected in the Northeast in 1999. The Company has budgeted capital expenditures of $115 million, including over $90 million for acquisitions. In the 1998/99 winter

Northeast Natural Gas Production

Annual Average (MMCF/D)	1998	% of Company Total	1997	% of Company Total
Duncan/Thornbury	40.7	13.6	42.3	18.8
Liege	29.8	9.9	15.8	7.0
Newby	20.7	6.9	13.7	6.1
West Kirby/East Grouse	19.4	6.5	21.1	9.4
Mills/Tweedie/Charron	17.2	5.7	15.2	6.7
South Chard	10.1	3.4	9.4	4.2
Algar	9.7	3.2	10.1	4.5
Clyden	6.9	2.3	6.8	3.0
Chard	6.1	2.1	6.3	2.8
Clyde Lake	6.0	2.0	5.0	2.2
Total	166.6	55.6	145.7	64.7

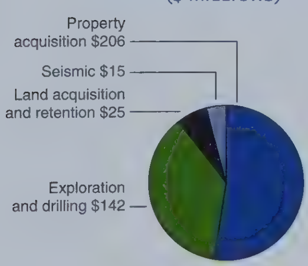
program, 33 wells were drilled, concentrating on the Newby, Chard and Liege areas. Incremental production from these wells currently totals 23 million cubic feet per day.

In the first quarter of 1999, a major acquisition was completed, adding a considerable presence along the eastern flank of this region. This acquisition strengthened the Company's holdings by adding four more complementary 100 percent-owned fields to the Company portfolio between the Newby and Chard areas. Production added was 35 million cubic feet per day along with undeveloped net acreage exceeding 166,000 acres. These acquisitions provide substantial volume growth and the undeveloped acreage acquired expands Rio Alto's prospect inventory. Initial drilling of these prospects was carried out this winter and should continue. Additional acquisitions are expected in 1999 as Rio Alto continues to position for future growth in this important region.

Northeast Net Natural Gas Production
(MMCF/D)

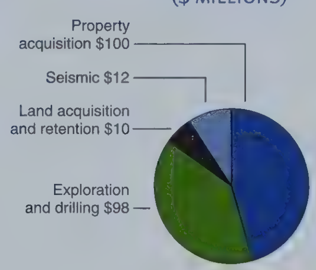
Steady production growth has been achieved year-over-year in the Northeast through a combination of drilling, acquisitions and facility optimization.

1998 Capital Expenditures ($ millions)



By pursuing active acquisition and drilling programs in its two core areas, Rio Alto expects to increase production 20 percent in 1999 over 1998 levels. With that level of production, the Company anticipates that capital expenditures will be almost completely funded by cash flow.

1999F Capital Expenditures ($ millions)



Management's Discussion and Analysis

For more than a decade, Rio Alto has been adding shareholder value through successful exploitation and rigid cost control.

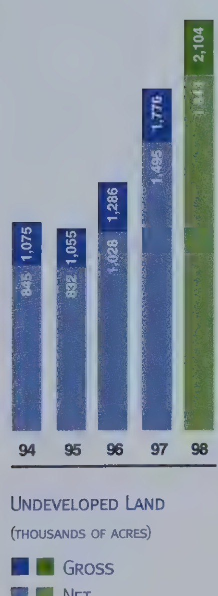
Overview

In 1998, Rio Alto continued its track record of year-over-year growth through the ongoing application of well-defined strategies. Production, revenues and cash flow all reached new records in 1998, assisted by the Company's maintenance of its low-cost operations.

In addition to a high level of successful drilling, Rio Alto completed a number of major acquisitions in 1998 to expand its ownership in new and existing operations. When combined with a number of smaller acquisitions, the Company experienced substantial growth in land holdings, production and reserves. With a strengthened position in its two core areas, including a large undeveloped land base and prospect inventory, Rio Alto is poised for future growth.

Land

Rio Alto's total net acreage rose 22 percent in 1998 as the Company pursued an aggressive program of strategic acquisitions. Net undeveloped land holdings increased 23 percent over last year to 1.8 million acres. The majority of the increase was in the Northwest core area where 482,000 net undeveloped acres were added, while holdings in the Northeast core area were maintained. This substantial growth in land holdings reflects the Company's drive to build a multi-year land and prospect inventory. The growth in total land holdings was accomplished with a combination of acquisitions (42 percent) and Crown land sales (58 percent).



Undeveloped Land
(thousands of acres)

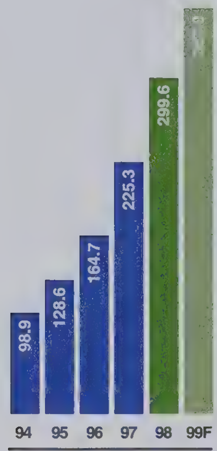
Drilling

Number of Wells Drilled/Depth Drilled (thousands of feet)

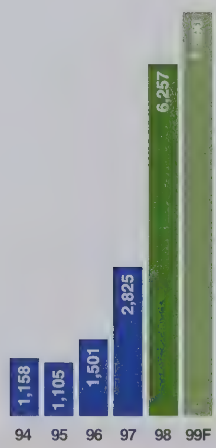
	GROSS	NET	NET SUCCESS %	GROSS FOOTAGE
1994	88	67.4	82.2	198
1995	113	98.8	82.3	175
1996	108	96.0	84.2	247
1997	189	169.1	80.7	538
1998	148	131.3	75.3	681

Annualized Drilling Results

	1998		1997	
WELLS	GROSS	NET	GROSS	NET
Gas	112	97.0	152	133.9
Oil	1	1.0	3	2.6
Service	1	0.8	–	–
Dry and abandoned	34	32.5	34	32.6
Total	148	131.3	189	169.1
Success Rate (%)	77	75.3	82	80.7



NATURAL GAS PRODUCTION
(MMCF/D)



OIL & NGL PRODUCTION
(BBLS/D)

Rio Alto continued to pursue an active drilling program in 1998 with 148 (131.3 net) wells. Overall depth drilled in 1998 represented the largest drilling program in the Company's history. The total footage drilled exceeded last year's total by over 25 percent. The 1998 net drilling success rate was over 75 percent. While slightly lower than in 1997, due to the higher emphasis on exploration wells in the Northwest, Rio Alto's net success rate has remained relatively stable year over year and well within the Company's target range.

Natural gas prospects accounted for the majority of drilling activity in 1998. Rio Alto drilled 97 net successful gas wells in 1998, of which the majority were immediately tied in for production.

Exploration drilling accounted for 10 percent of Rio Alto's 1998 drilling program. The activity occurred throughout the Company's active exploration areas. A total of 77 (65.1 net) wells were drilled in the Northwest, yielding 60 gas wells and one oil well. Overall, the Company's net success ratio was 75 percent. In the Northeast, 71 (66.2 net) wells were drilled with a net success rate of 73 percent. Overall, on a footage basis the Company drilled more depth in the Northwest due to the increased number of wells drilled in the area but on a well basis the balance was fairly equal. Throughout the year, the Company continued to expand its use of horizontal drilling, particularly in the Liege area of Northeast Alberta. In the Northwest, the 1998 drilling program grew natural gas production by 35 percent and liquids production by 75 percent. In the Northeast, where production is solely natural gas, drilling increased production volumes by 11 percent over last year.

The 1999 winter drilling program was completed in March. The Company drilled 50.6 net wells in the Northwest and 32.4 net wells in the Northeast, with an overall success rate of 75 percent. During the remainder of the year, Rio Alto will focus on identifying and refining its winter 1999 - 2000 drilling program.

PRODUCTION

Rio Alto's total net production grew by 43 percent on a million cubic feet per day equivalent basis, which once again met the Company's target set for the year.

Natural gas comprised more than 83 percent of Rio Alto's production mix in 1998. Average natural gas volumes increased 33 percent to reach a record 300 million cubic feet per day. Currently, 56 percent of the Company's natural gas production split is from the Northeast core region while 44 percent originates in the Northwest. In 1999, Rio Alto anticipates natural gas production to average 367 million cubic feet per day, with 52 percent from the Northeast and 48 percent from the Northwest.

While only a relatively small component of the total volume mix, crude oil and natural gas liquids production increased 121 percent in 1998 to 6,257 barrels per day. As Rio Alto continues to explore and exploit liquids-rich gas reserves in the Northwest core region, natural gas liquids volumes are expected to grow. Rio Alto is forecasting crude oil and natural gas liquids production to average 7,300 barrels per day in 1999.

Reserves

Natural Gas Reserves (bcf)

	PROVEN	PROBABLE	TOTAL
1994	265	68	333
1995	318	66	384
1996	436	69	505
1997	772	178	950
1998	1,000	263	1,263

Oil and NGL Reserves (mbbls)

	PROVEN	PROBABLE	TOTAL
1994	2,580	1,368	3,948
1995	2,925	1,260	4,185
1996	4,228	1,949	6,177
1997	19,913	8,036	27,949
1998	29,279	11,663	40,942

Rio Alto's total proven plus probable reserves grew to 1,672 billion cubic feet of natural gas equivalent, up 36 percent compared to last year. The Company's reserve replacement ratio was 343 percent, compared to 632 percent in 1997 (due to Rio Alto's acquisition of Seagull Energy Canada Ltd. in 1997).

Proven plus probable natural gas reserves increased 33 percent over 1997 to 1.26 trillion cubic feet. Of that amount, proven reserves grew 29 percent to 1.0 trillion cubic feet, while probable reserves increased 48 percent to 263 billion cubic feet.

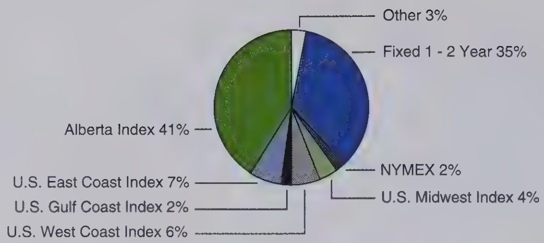
Proven crude oil and natural gas liquids reserves increased almost one and a half times, to 29.3 million barrels, over 1997 levels. Growth in proven plus probable crude oil and natural gas liquids reserves was 46 percent over last year, to total 40.9 million barrels. These significant gains were the result of major acquisitions in the Northwest at Gold Creek and Minehead, along with successful development at Karr, Edson and Gold Creek. As a result of the acquisition program, the Company's finding and development costs increased to $7.55 per barrel of proven plus half probable oil equivalent reserves in 1998, but remained below the industry average of $8.72. Rio Alto's higher finding and development costs were incurred due to the price of high-quality assets acquired in the current industry environment.

Marketing

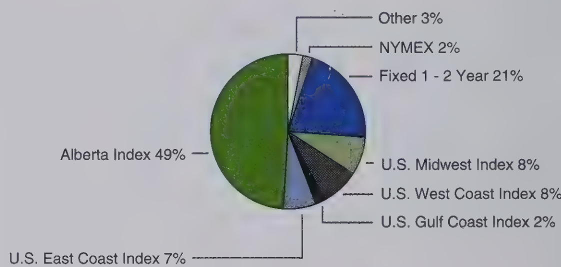
Rio Alto maintains a diversified balanced marketing portfolio with the flexibility to adjust to pricing and market conditions as they arise. Sales are balanced between long-term aggregators and short-term and fixed-price contracts. In November 1998, Rio Alto reduced the volumes being exported to the United

Natural Gas Prices
($/mcf)

Oil and NGL Prices
(Cdn$/bbl)



1998 Gas Sales Portfolio
as at November 1998



1999 Gas Sales Portfolio
Forecast as at November 1999

Revenue
($millions)

States to 27 percent from 45 percent in the prior year. This strategic shift was undertaken to take advantage of higher Alberta spot market prices. The remaining volumes are dedicated to fixed contracts, maintaining the balanced profile.

Natural gas prices in 1998 started off the year at the low end of expectations, due largely to an unseasonably warm winter across much of North America. However, prices rebounded later in the year when it became apparent that field receipts were not keeping pace with demand from recent pipeline expansions. Rio Alto remains optimistic about Canadian gas pricing due to the opening of the Northern Border Pipeline expansion to Chicago in mid-December, adding 700 million cubic feet per day of additional export capacity. In addition, the Alliance Pipeline project is expected to be completed late in the year 2000 providing an additional 1.3 billion cubic feet per day of pipeline transportation from Alberta to the Chicago market. These pipelines have closed the significant price gap that existed between U.S. and Alberta gas prices to the benefit of Canadian producers.

The Company's diversity in markets and contracts enabled Rio Alto to achieve an average price of $1.98 per thousand cubic feet in 1998. In 1999, the Company anticipates the average price to rise to $2.25 per thousand cubic feet.

Oil and natural gas liquids are contracted annually to markets offering the highest netbacks. In 1998, the Company received an average blended price of Cdn$14.29 per barrel. In 1999, prices are expected to generate an average price of Cdn$15.00 per barrel.

Revenue

Revenue growth in 1998 was achieved primarily through higher natural gas production, which increased 33 percent over 1997. In addition, the average gas price Rio Alto realized for the year was $1.98 per thousand cubic feet, just slightly lower the 1997 average of $2.01. The average crude oil and natural gas liquids price was $14.29 per barrel in 1998, down 35 percent from $22.02 in 1997. The substantial growth in crude oil and natural gas liquids production offset the decline in the average liquids price and, as a result, total revenue was up 32 percent to $247.5 million in 1997.

Royalties and Operating Expenses

Total 1998 operating expenses were $37.0 million, compared to $24.8 million in 1997. Natural gas operating costs were $0.23 per thousand cubic feet, no change from 1997, while crude oil and natural gas liquids operating expenses were $4.88 per barrel of oil equivalent, down three percent from 1997. While unit gas expenses remained flat and unit liquids costs were reduced, the overall unit expense level increased due to the higher level of liquids in the total product mix. Overall operating expenses on a barrel of oil equivalent basis increased by only $0.12 over 1997 and, as in the past five years, remained well below industry norms.

Overall royalties of $39.0 million were 15.8 percent of gross sales in 1998, compared to 18.7 percent in 1997. This decrease was due to adjustments to gas cost allowance for 1996, 1997 and 1998.

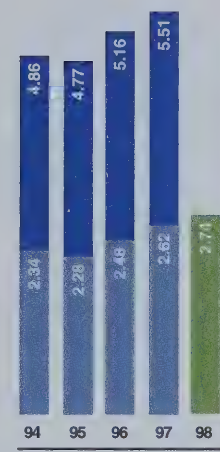
General and Administrative Expenses

General and administrative expenses have remained relatively constant over the past five years. General and administrative expense averaged $0.71 per barrel of oil equivalent in 1998 compared to $0.74 in 1997, well below Rio Alto's target of $0.80 per barrel of oil equivalent and significantly lower than the industry average.

General and administrative expenses increased to $9.4 million in 1998 compared to $6.9 million in 1997. This change was attributable to the larger staff complement now in place to support continued strong production growth. No general and administrative expenses were capitalized in 1998 or in 1997.

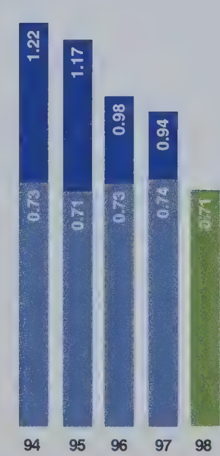
Interest Expenses

Rio Alto's interest expense increased to $24.9 million from $10.0 million in 1997. This rise resulted from higher interest rates and overall higher debt carried by the Company to complete acquisitions to expand the asset portfolio. However, the unit debt servicing cost has remained steady at $0.19 per barrel of oil equivalent, comfortably within the Company's target range. The overall average interest rate increased to 5.6 percent from 4.4 percent in 1997. The year-end debt, net of working capital, increased to $470.1 million in 1998 versus $336 million during 1997.



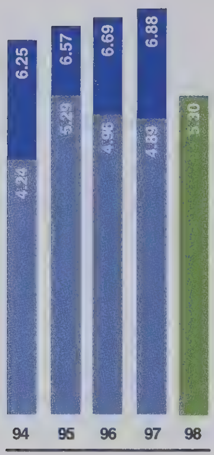
Operating Expenses
($/boe)

Industry Average
Rio Alto



General and Administrative Expenses
($/boe)

Industry Average
Rio Alto



Depletion and Depreciation
($/boe)

Industry Average
Rio Alto

Depletion and Depreciation

The depletion and depreciation rate increased slightly to $5.30 per barrel of oil equivalent for 1998, still significantly lower than the industry average. The 1998 increase was due to a higher finding and development cost resulting from Rio Alto's aggressive acquisition program. Total depletion and depreciation provision rose to $70.0 million in 1998 compared to $45.4 million in 1997, a direct result of higher production levels.

Income Taxes

No provision was required for current taxes in 1998 as the Company had sufficient tax pools available to shelter current tax. It is anticipated that sufficient tax pools will be available to shelter any current tax that would otherwise be payable during 1999.

Cash Flow and Net Income

($MILLIONS, EXCEPT PER SHARE AMOUNTS)	1998	1997	1996	1995	1994
Cash flow	135.6	108.8	71.2	39.7	46.0
Cash flow per share	2.18	2.05	1.49	0.90	1.12
Net income	37.2	36.1	22.9	7.9	16.9
Earnings per share	0.60	0.68	0.48	0.18	0.41

Cash flow from operations rose 25 percent in 1998 to $135.6 million, while cash flow per share was up six percent to $2.18 for 1998. The increase stemmed predominantly from higher production levels, which also contributed to an increase in net income to $37.2 million, a three percent increase over 1997. On a per share basis, earnings were $0.60 compared to $0.68 per share in 1997, reflecting the lower product pricing and larger shareholder base subsequent to the share offering in May 1998.

Capital Expenditures

Capital spending in 1998 totalled $388 million, down from $404 million in 1997. Of the total, $230 million was spent on acquisitions and land. Total expenditures were funded by cash flow (35 percent), new equity (25 percent) and bank debt (40 percent). The 1999 capital budget is currently set at $220 million, of which $110 million will be spent on drilling activities and facility construction and maintenance.

Liquidity and Capital Resources

At year-end 1998, Rio Alto had positive working capital with a current ratio of 1.62:1. The Company's revolving bank loan capacity at December 31, 1998 was $575 million, with the unused portion being $74 million. Net of working capital, Rio Alto exited the year with a net long-term debt of $470.1 million.

Risk Management

In its day-to-day business, Rio Alto assumes risks which include production operations, uncertainty of reserve size, availability of and access to markets, economic volatility and environmental issues.

Due to the effectiveness and track record of its program in prior years, Rio Alto's risk management strategy remained largely unchanged in 1998 and will be maintained during 1999. The Company's active risk management program is underpinned by highly skilled and experienced employees in both the head office and in the field, as well as by employing state-of-the-art, quality equipment at all facilities and wellsites. For example, remote locations are controlled by SCADA systems that relay information almost instantly, allowing problems to be recognized and attended to quickly and efficiently. Rio Alto also maintains and replaces equipment on a regular basis, eliminating the threat of incidents that result from wear and tear. Other important components of Rio Alto's risk management program include maintaining high working interests in all properties and the use of in-house expertise in producing and marketing natural gas.

As the Company's property and equipment inventory has grown, so has the need for dedicated attention to the various aspects of risk management. Rio Alto employs a full-time staff member responsible for safety and environmental risk. As a result, Rio Alto is able to remain proactive on issues of environmental and safety management. Ongoing risk audits on all projects remain a key component of this process.

Year 2000 Compliance

Rio Alto has completed an assessment of the Company's year 2000 exposure to potential problems with computer hardware and software, administration systems, communications, field instrumentation and environmental equipment. The program to correct all identified internal problems by replacement or repair is approximately 95 percent complete and is scheduled to be completed by the end of the second quarter of 1999. The assessment revealed that Rio Alto's exposure was less than originally anticipated and the associated cost of correction, estimated at $540,000, is not expected to have a material impact on the Company's financial position. Of these costs, $135,000 was incurred and charged in 1998. Overall, one-third of the total cost relates to the purchase of new equipment and will be capitalized; the remainder will be expensed in the financial statements. Fully half of the estimated expenditures represents accelerated purchases of hardware and software systems already identified for future use.

Rio Alto has started contingency planning to address methods of dealing with unforeseen circumstances related to the year 2000, due to problems originating outside the control of the Company, such as joint venture partners, suppliers of field parts and services, and service providers such as banks and insurance companies. Through Rio Alto's involvement in the Oil and Gas Industry Joint Effort, the Company is taking steps to deal with unpredicted problems. Company-wide year 2000 contingency planning is scheduled to be completed by the third quarter of 1999.

Management's Report

Management is responsible for all information presented in this annual report. The financial data contained throughout the report has been reviewed to ensure consistency with the consolidated financial statements.

Management maintains a system of internal accounting controls designed to provide reasonable assurance that assets are safeguarded, transactions are properly authorized and financial reports are properly maintained to facilitate the preparation of relevant and reliable financial information.

The Audit Committee of the Board of Directors, which is comprised of a majority of non-management directors, has reviewed the financial statements with management and PricewaterhouseCoopers LLP. The Board of Directors has approved the consolidated financial statements.

Richard T. Cones *President and* *Chief Financial Officer*	**Robert M. Shaunessy** *Executive Vice President, Operations* *and Chief Operating Officer*	**Doug K. Smith** *Controller*

February 22, 1999

Auditors' Report

To the Shareholders of Rio Alto Exploration Ltd.

We have audited the consolidated balance sheets of Rio Alto Exploration Ltd. as at December 31, 1998 and 1997 and the consolidated statements of income and retained earnings and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1998 and 1997 and the results of its operations and cash flow for the years then ended in accordance with generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants
Calgary, Alberta
February 22, 1999

Consolidated Balance Sheet

YEARS ENDED DECEMBER 31 ($THOUSANDS)	1998	1997
Assets		
Current Assets		
Cash	$ –	$ 103
Accounts receivable	59,686	37,920
Inventory	20,580	19,131
	80,266	57,154
Property, plant and equipment (Notes 2 and 3)	1,023,511	705,907
	$ 1,103,777	$ 763,061
Liabilities and Shareholders' Equity		
Current liabilities		
Accounts payable and accruals	$ 45,875	$ 42,267
Current portion of obligations under capital leases	3,678	977
	49,553	43,244
Long-term debt (Note 4)	500,830	350,000
Obligations under capital leases (Note 5)	16,007	2,238
Deferred income tax	115,711	89,142
Shareholders' equity		
Share capital (Note 6)	282,499	176,468
Retained earnings	139,177	101,969
	421,676	278,437
	$ 1,103,777	$ 763,061

Approved by the Board,

Richard T. Cones

Director

N. Murray Edwards

Director

Consolidated Statement of Income and Retained Earnings

YEARS ENDED DECEMBER 31 ($THOUSANDS, EXCEPT PER SHARE AMOUNTS)	1998	1997
Revenue		
Oil and natural gas sales	$ 247,507	$ 186,812
Less: Royalties, net of Alberta Royalty Tax Credit	39,017	35,062
	208,490	151,750
Expenses		
Production	36,987	24,813
Administration	9,408	6,887
Interest on long-term debt	24,902	10,037
Depletion and depreciation	69,988	45,376
	141,285	87,113
Income before income taxes	67,205	64,637
Capital taxes	1,569	1,182
Deferred income tax	28,428	27,316
	29,997	28,498
Net income	37,208	36,139
Retained earnings, beginning of year	101,969	65,830
Retained earnings, end of year	$ 139,177	$ 101,969
Earnings per share	$ 0.60	$ 0.68

CONSOLIDATED STATEMENT OF CASH FLOW

YEARS ENDED DECEMBER 31 ($THOUSANDS, EXCEPT PER SHARE AMOUNTS)	1998	1997
CASH PROVIDED BY OPERATING ACTIVITIES		
Net income for the year	$ 37,208	$ 36,139
Items not involving cash		
Deferred income tax	28,428	27,316
Depletion and depreciation	69,988	45,376
Funds generated from operations	135,624	108,831
Increase (decrease) in non-cash working capital	(19,607)	3,752
	116,017	112,583
FINANCING ACTIVITIES		
Proceeds on issuance of share capital, net	104,172	81,500
Payments of obligations under capital leases	(3,530)	(1,375)
Issuance of long-term debt and obligations under capital lease	170,830	211,000
	271,472	291,125
INVESTING ACTIVITIES		
Acquisition of property, plant and equipment		
Acquisition of 764032 Alberta Ltd. (Note 2)	(86,791)	–
Acquisition of Seagull Energy Canada Ltd. (Note 2)	–	(260,017)
Crown land acquisition and retention	(24,644)	(27,681)
Exploratory seismic	(14,993)	(17,695)
Property acquisitions	(120,004)	(69,871)
Proceeds on disposition	1,035	111,863
Exploration and development	(142,195)	(140,596)
	(387,592)	(403,997)
Increase (decrease) in cash	(103)	(289)
Cash, beginning of year	103	392
Cash, end of year	$ –	$ 103
Cash flow from operations per share	$ 2.18	$ 2.05

Notes to Consolidated Financial Statements

FOR THE YEARS ENDED DECEMBER 31, 1998 AND 1997

(TABULAR AMOUNTS IN THOUSANDS OF DOLLARS, EXCEPT WHERE INDICATED)

1. Summary of Significant Accounting Policies

a) Consolidated financial statements

The consolidated financial statements of the Company have been prepared by management in accordance with accounting principles generally accepted in Canada. The consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries and its general partnership.

b) Petroleum and natural gas properties and equipment

The Company follows the full cost method of accounting wherein all costs associated with the exploration for and development of oil and gas reserves in Canada are capitalized. Costs capitalized include land acquisitions, geological and geophysical costs, rentals on undeveloped properties, costs of drilling productive and non-productive wells, lease and well equipment and overhead. Gains or losses are not recognized upon disposition of oil and gas properties unless they would significantly alter the rate of depletion.

The Company's exploration and production activities are conducted jointly with others and these consolidated financial statements reflect the Company's proportionate interest in such activities.

The costs related to petroleum and natural gas properties are depleted using the unit-of-production method, based on estimated proven oil and gas reserves as determined by the Company and independent engineers. Oil and natural gas reserves are converted to a common unit of measure on the basis of their relative energy content. In determining its depletion base, the Company includes estimated future costs to be incurred in developing proven reserves and excludes the cost of undeveloped land. Gas plants and pipelines are depreciated over the estimated useful life of the facility.

The Company performs a ceiling test to ensure its petroleum and natural gas properties are carried at the lower of the capitalized cost and net recoverable value. Capitalized cost is calculated as the net book value of the related assets less deferred income tax. Net recoverable value is limited to the sum of the estimated undiscounted value of future net revenues from proven oil and gas reserves, based on current prices and costs, less estimated future general and administrative expenses, financing and restoration costs and income taxes. Oil and gas prices at December 31, 1998 of $11.19 per barrel of oil and $2.34 per thousand cubic feet of gas were used; there was a significant surplus. The Company annually reviews the costs associated with undeveloped properties to assess whether the costs will likely be recoverable.

c) Per share statistics

Cash flow from operations per share is determined by funds generated from operations which is based on net income before depletion and depreciation and deferred income tax.

d) Financial instruments

Financial instruments are used to hedge market risks related to commodity prices and interest rates. The related gains or losses are recorded in the statement of income in the period in which the underlying hedged transactions are recognized. The Company does not use these instruments for trading purposes.

e) Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from these estimates.

f) Inventory

Inventory consists of pipe stock, deposits on equipment being manufactured and other production equipment that is held for use and possible resale. Inventory is valued at the lower of cost and replacement cost.

g) Comparative figures

Certain comparative figures have been restated to conform to the presentation adopted in the current year.

2. Acquisitions

a) **Acquisition of 764032 Alberta Ltd.**

Pursuant to a share sale agreement during 1998, the Company acquired all of the issued and outstanding shares of 764032 Alberta Ltd. ("764032"), a company engaged in the business of oil and gas exploration and development. The acquisition has been accounted for using the purchase method and the results of operations of 764032 have been included in these financial statements from the date of the acquisition.

Net assets acquired	
Property, plant and equipment	$ 86,791
Financed by	
Cash	$ 86,791

b) **Acquisition of Seagull Energy Canada Ltd.**

Pursuant to a share sale agreement during 1997, the Company acquired all of the issued and outstanding shares of Seagull Energy Canada Ltd. ("Seagull"), a company engaged in the business of oil and gas exploration and development. The acquisition has been accounted for using the purchase method and the results of operations of Seagull have been included in these financial statements from the date of the acquisition.

Net assets acquired	
Property, plant and equipment	$ 279,579
Working capital surplus	522
Deferred income taxes	(20,084)
Net assets acquired before dispositions	260,017
Proceeds on dispositions	(110,090)
	$ 149,927
Financed by	
Cash	$ 149,927

3. Property, Plant and Equipment

	1998	1997
Petroleum and natural gas properties	$ 1,235,033	$ 847,441
Less: accumulated depletion and depreciation	(211,522)	(141,534)
	$ 1,023,511	$ 705,907

Undeveloped properties not subject to depletion amounted to $222,398,400 at December 31, 1998 (1997 - $146,935,600). Management has estimated the salvage value of the equipment to be in excess of the abandonment cost of the petroleum and natural gas properties and, accordingly, no provision has been recorded in the accounts for future removal and site restoration costs. Petroleum and natural gas properties in an amount of $192,232,300 (1997 - $116,518,300) have no tax bases.

The Company did not capitalize any administrative expenses during 1998 and 1997.

4. Long-Term Debt

	1998	1997
Revolving bank loans		
Bankers' acceptances	$ 399,000	$ 285,000
Interest rate swaps (Note 8)	100,000	65,000
Prime loan	1,830	–
	$ 500,830	$ 350,000

As at December 31, 1998, the Company has a total unsecured credit facility of $575,000,000 (1997 - $365,000,000) comprised of a $525,000,000 revolving credit facility and a $50,000,000 operating demand facility. The bank facility provides that borrowings may be made by way of operating advances, prime loans or bankers' acceptances which bear interest at the bank's prime rates or at money market rates plus a stamping fee. The $525,000,000 revolving credit facility

as well as the $50,000,000 standard operating facility are redetermined annually by July 31 based on the estimated future net revenues of oil and gas properties. If any shortfalls in the borrowing base arise, they are to be repaid during the following year. Principal payments are not anticipated in 1999.

The Company may not, amongst other things, dispose of material assets, pay dividends or redeem shares without the prior consent of its banks.

5. Obligations Under Capital Leases

	1998	1997
Total obligations under capital leases	$ 19,685	$ 3,215
Less: current portion	(3,678)	(977)
	$ 16,007	$ 2,238

The obligations under capital leases bear interest at an average interest rate of 6.8 percent and are secured by the related assets.

Future minimum lease payments under capital leases are as follows:

1999	$ 4,974
2000	5,672
2001	4,329
2002	8,050
	23,025
Amount representing interest	(3,340)
Total obligations under capital leases	$ 19,685

6. Share Capital

Authorized

An unlimited number of preferred shares, issuable in series, designated as First Preferred Shares and Second Preferred Shares

An unlimited number of common voting shares

a) Issued and outstanding common shares

(thousands of shares)	Shares	Stated value
Balance, December 31, 1996	49,638	$ 93,560
Shares issued for cash		
Public offering	6,500	74,628
Options exercised	1,488	8,280
Balance, December 31, 1997	57,626	176,468
Shares issued for cash		
Public offering	6,000	99,092
Options exercised	1,001	6,939
Balance, December 31, 1998	64,627	$ 282,499

Pursuant to a public offering during 1998, the Company issued 6,000,000 common shares at a price of $16.90 per share for total proceeds of $101,400,000 before costs of the issue. Costs of the issue, net of associated income tax effects of $1,859,300 were $2,307,700, and have been recorded as a reduction of share capital.

Pursuant to a public offering during 1997, the Company issued 6,500,000 common shares at a price of $11.75 per share for total proceeds of $76,375,000 before costs of the issue. Costs of the issue, net of associated income tax effects of $1,407,800 were $1,747,200, and have been recorded as a reduction of share capital.

b) During 1998, the Company issued options to purchase 435,000 common shares to senior management and directors at a price of $10.25 per share and vesting over five years and 1,294,150 common shares to employees ranging in price from $10.25 to $14.65 per share and vesting over five years. As at December 31, 1998, options to purchase 4,707,270 common shares were outstanding at prices ranging from $3.50 to $14.65 per share and expire from November 30, 1999 to October 1, 2003.

7. Income Taxes

Income tax expense varies from the amounts that would be computed by applying the Canadian federal and provincial income tax rates to earnings before income taxes. The reconciliation of the combined statutory income tax rate and the effective income tax rate is as follows:

(%)	1998	1997
Statutory rate	44.6	44.6
Increase (decrease) in income taxes resulting from:		
Non-deductible Crown royalties, lease rentals and depletion and depreciation	28.7	26.7
Resource allowance	(29.5)	(24.1)
Other	0.8	(3.1)
Effective rate	44.6	44.1

8. Financial Instruments and Commitments

The Company enters into forward swaps to manage its exposure to price fluctuations on hydrocarbon transactions and interest rates. All transactions of this nature entered into by the Company are related to an underlying physical or financial position, firm commitment or to future oil and gas production. The Company does not use derivative financial instruments for trading purposes. The counterparties to these transactions are major financial institutions and therefore the risk of credit loss is considered remote.

The net effect of natural gas and oil and natural gas liquids forward swaps is to convert specific sales contracts from indexed market prices to fixed prices in order to hedge against declining prices. There were no significant forward swaps on hydrocarbon transactions outstanding at December 31, 1998.

At December 31, 1998, the Company had swapped the interest payments on $100,000,000 of the revolving bank loans into a fixed interest rate of 5.08 percent plus the stamping fee maturing on March 30, 2001. The bank has a one day option on March 30, 2001 to extend the swap until March 31, 2004.

Estimated fair values of the Company's financial instruments approximated the carrying values on the financial statements as at December 31, 1998.

In the normal course of business the Company has entered into contracts for the purchase of transportation capacity, materials and services at fixed prices over terms of up to 10 years. The remaining payments required under these contracts at December 31, 1998 totalled $29.9 million. In the opinion of management, it is unlikely that any loss will be incurred as a result of these contracts.

9. Uncertainty Due to the Year 2000 Issue

The year 2000 issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the year 2000 issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect an entity's ability to conduct normal business operations. It is not possible to be certain that all aspects of the year 2000 issue affecting the entity, including those related to the efforts of customers, suppliers, or third parties, will be fully resolved.

The Company has initiated a review to address the year 2000 compliance of information systems and process control technology. Based on this review the Company has implemented a remediation effort to mitigate risks associated with the year 2000 issue. It is anticipated that future costs associated with this effort will not be significant.

Five Year Review

	1998	1997	1996	1995	1994
Financial ($thousands, except per share amounts)					
Revenue					
Oil and gas sales	247,507	186,812	116,026	71,594	74,215
Royalties, net of ARTC	39,017	35,062	15,227	7,281	10,935
	208,490	151,750	100,799	64,313	63,280
Expenses					
Production	36,987	24,813	17,065	11,870	9,706
Administration	9,408	6,887	4,776	3,614	2,101
Interest	24,902	10,037	6,982	8,686	5,014
Depletion and depreciation	69,988	45,376	32,502	26,970	17,084
	141,285	87,113	61,325	51,140	33,905
Income before income taxes	67,205	64,637	39,474	13,173	29,375
Capital taxes	1,569	1,182	742	437	408
Deferred income tax	28,428	27,316	15,881	4,796	12,101
Net income	37,208	36,139	22,851	7,940	16,866
Per share	0.60	0.68	0.48	0.18	0.41
Cash flow	135,624	108,831	71,234	39,706	46,051
Per share	2.18	2.05	1.49	0.90	1.12
Balance sheet information					
Capital expenditures, net	387,592	403,997	120,221	66,787	130,946
Total assets	1,103,777	763,061	372,380	259,986	226,260
Long-term debt, net of working capital	470,117	336,090	121,563	99,135	74,057
Shareholders' equity	421,676	278,437	159,390	109,335	101,177
Weighted average shares outstanding (thousands)	62,118	53,075	47,961	44,322	41,222
Operating					
Production					
Natural gas (mcf/d)	299,600	225,300	164,700	128,600	98,900
Oil and NGLs (bbls/d)	6,257	2,825	1,501	1,105	1,158
Average natural gas price ($/mcf)	1.98	2.01	1.72	1.37	1.85
Average oil and NGLs price ($/bbl)	14.29	22.02	22.53	19.99	18.44
Operating costs combined ($/boe)	2.74	2.62	2.48	2.28	2.34
Reserves - proven plus probable					
Natural gas (bcf)	1,263	950	505	384	333
Oil and NGLs (mbbls)	40,942	27,949	6,177	4,185	3,948
Wells drilled					
Gross	148	189	108	113	88
Net	131.3	169.1	96.0	98.8	67.4
Land holdings (thousands of acres)					
Gross	3,009	2,584	1,904	1,657	1,561
Net	2,523	2,064	1,444	1,225	1,052

Corporate Information

ɹectors

ɪn A. Brussa
rtner
rnet, Duckworth & Palmer

chard T. Cones
esident and Chief Financial Officer
ɔ Alto Exploration Ltd.

Murray Edwards
esident
ɪco Financial Holdings Ltd.

ɪbert M. Shaunessy
ecutive Vice President, Operations
d Chief Operating Officer
ɔ Alto Exploration Ltd.

ɪyd C. Swift
esident
uare Butte Resources Inc.

ficers and Senior Management

ul P. Bourget
nager, Production
rtheast/Northwest Alberta

orge W. Clutton
a Superintendent,
rthwest Central and South Area

hard T. Cones, P. Eng.
sident & Chief Financial Officer

Lavonne M. Dubois, P. Land
Manager, Land

Luis M. Ferreira, P. Eng.
Manager, Marketing

Don C. Klapko
Manager, Facilities and
Operating Engineering

Andrew G. Krancz
Area Superintendent,
Northeast Alberta

Murray R. Nunns, P. Geol.
Vice President, Exploration
and Development

Robert M. Shaunessy, P. Eng.
Executive Vice President, Operations
and Chief Operating Officer

Doug K. Smith, C.A.
Controller

Ken J. Stecyk, P. Eng.
Manager, Drilling and Completions

Gordon W. Stevens
Area Superintendent,
Grande Prairie Area

Ian J. Towers, P. Eng.
Manager, Corporate Development

Bruce R. Wilson, P. Eng.
Manager, Production
Grande Prairie Area

Rob E. Wollmann
Manager, Exploration

Dwayne G. Woychuk, P. Eng.
Manager, Joint Ventures

Head Office

Rio Alto Exploration Ltd.
2500, 205 - 5th Avenue S.W.
Calgary, Alberta T2P 2V7
Telephone: (403) 264-8780
Fax: (403) 261-7626

Legal Counsel

Burnet, Duckworth & Palmer

Auditors

PricewaterhouseCoopers LLP

Registrar and Transfer Agent

CIBC Mellon Trust Company

Bankers

Royal Bank of Canada
Canadian Imperial Bank of Commerce
Bank of Montreal
Toronto Dominion Bank

Evaluation Engineers

NRG Engineering Ltd.

Stock Exchange Listing

Toronto Stock Exchange
Symbol: RAX

Created by Result Communications Ltd.
Printed in Canada

RIO ALTO EXPLORATION LTD.
2500, 205 - 5th Avenue S.W.
Calgary, Alberta
T2P 2V7